would be needed to ensure voluntary supply, it must base its plan on an average support amount. Short of paying support high enough for the least desirable customer, this will not ensure that all customers are served, unless it is tied to an effective obligation to serve. The plan would effectively require the carrier to accept an amount that might be too much for customer D, and not enough for customer A, but which is reasonable on average.

In order for the obligation to be effective, however, each carrier who undertakes the obligation, and receives the average support amount, must have the same obligations. Further, the carrier must be required to offer service at a price which does not exceed the level the state commission finds affordable, in a stand-alone offering which meets the basic service definition, but which does not bundle serves in such a way that the customer is forced to buy other features in order to obtain the basic service. Without such a specification, the obligation to serve is meaningless, because the carrier will be able to serve selectively, as demonstrated *supra*.

This specification of responsibility is an essential component of a successful universal service plan. It represents the regulator's specification of what the universal service provider is intended to do in return for the support provided. It is the market intervention that universal service is intended to maintain. Because the *Recommended Decision* does not require states to establish an effective obligation to serve, it cannot be competitively neutral, and it will never be sufficient.

B. Use Of The *Recommended Decision*'s "Nationwide-Average-Revenue" Benchmark Methodology Cannot Produce A Valid Calculation Of The Need For Support Under The Statutory Mandate And Will Force Carriers To Depend On Implicit Subsidies In Violation Of The 1996 Act.

The *Recommended Decision* (at ¶¶ 309-310) proposes that the amount of high cost support be determined based upon the difference between the hypothetical cost of providing universal service and a nationwide average revenue "benchmark." The benchmark would represent the nationwide average revenues derived from local, discretionary,[34] and access services.

GTE supports the use of a benchmark as part of an integrated framework for the federal plan. But, given the recommendation (at ¶ 131) that the states should determine the affordable rate, the federal benchmark should serve only as a means to divide funding responsibility between federal and state mechanisms. GTE will discuss *infra* the basis on which the choice of such a benchmark should be made.

As set forth in the *Recommended Decision*, however, the construction of the benchmark is part of the Joint Board's general pattern of avoiding the essential issues of universal service. The *Recommended Decision* (at ¶ 317) justifies its choice of the average revenue methodology as a means to "establish the need for support." Unfortunately, the method proposed would dramatically underestimate the total need for support. If the total need for funding were actually determined on this basis, the support for universal service would be insufficient and would perpetuate implicit

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[34] Such as call waiting, call forwarding and caller ID.

support. For these reasons, GTE urges the Commission not to adopt a benchmark constructed on the proposed basis for the federal plan.

The recommended method is unreasonable as a means of determining the total need for support because it proposes to consider revenues from services which are not part of the "core" service definition. This approach is impermissible because it would incorporate into the new universal service plan the same implicit support flows which are used today, in violation of Section 254(e), which requires that universal service support be explicit.

The *Recommended Decision* suggests (at ¶ 185) that these revenues represent "the amount the carrier would expect to recover from other services to cover the cost of providing supported services." In fact, no such expectation would be reasonable, for several reasons.

First, the rates for many of these services have been set at artificially high levels in order to generate support for universal service. These rates cannot be sustained at current levels in a competitive market and will come down in the near future, through market pressure, actions taken by the Commission in universal service and access reform proceedings, and substitution from unbundled elements.[35] Therefore no carrier could reasonably expect that it could rely on the current level of revenue from those

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[35] For example, the *Recommended Decision* would include vertical services at current rate levels. Yet the Commission's *Interconnection Order* (at ¶ 268)would require LECs to sell these functions at no charge to purchasers of unbundled switching.

services, even on average.[36] It is precisely because the current implicit supports are unsustainable that Congress has recognized the need to replace them with an explicit mechanism.

Second, the demand for services like access and vertical services is highly skewed; a small proportion of the customers generates a large proportion of the demand.[37] This means that a carrier that targets customers with high levels of usage can enjoy revenue much greater than the average. As shown *supra*, because the *Recommended Decision* does not include an effective obligation to serve, a new entrant will be able to serve selectively, within the proposed rules, and receive high-cost support for doing so. While the new local carrier serves its high revenue target market, the ILEC, which does have a service obligation, will be left with an average revenue much less than the national average.

Third, the mere fact that a carrier provides local service to a customer does not guarantee it "follow-on" revenues from other services. In a world of unbundling and equal access, a customer may choose one supplier for local service, and another supplier for other services.

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[36] The *Recommended Decision* acknowledges (at ¶ 310) that this decline in the rates of follow-on services will occur. However, it offers no better remedy than periodic review of the benchmark. This amounts to an admission that the benchmark amount will be too low between reviews.

[37] For GTE's serving areas in aggregate, for example, only 6% of the end user locations account for almost half of the demand for switched access.

Fourth, the amount of "follow-on" revenue varies dramatically from one place to another, even on average. This means that a level of support calculated on the basis of a nationwide average will simply be insufficient in many areas.[38]

The *Recommended Decision* offers a curious justification for this averaging: it claims (at ¶ 313) that the use of a nationwide average revenue will give carriers an incentive to increase demand for follow-on services in areas where demand is currently low. This confuses incremental incentives with levels. The incentive for any firm to increase revenue by an additional dollar is the same: one dollar (net of any associated incremental costs). The starting level of revenue in a particular area does not affect this at all.[39] Yet it is clear that some customers will always have less demand than others, regardless of any efforts firms may make to promote demand.[40] Hence any support determined using average revenue must be insufficient in places where revenue is less than average.

The *Recommended Decision* (at ¶ 311) expresses concern that if revenues for other services are not counted, there may be a mismatch between the revenues

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[38] For example, in GTE's serving areas, customers in urban areas generate average revenues for vertical services about one-third higher than the average for customers in rural areas (defined according to the Office of Management and Budget criteria proposed at ¶ 680.) Because rural areas are more likely to be the recipients of high cost support, a system based on average revenues will systematically understate support requirements.

[39] In fact, as shown *supra*, the most powerful incentive will be for carriers to serve high-revenue customers and avoid low-revenue ones.

[40] This would be particularly true in those locations that just happen to be characterized by high-cost and low-income.

considered and the costs captured by the proxy model. This is illogical, for several reasons.

1. The cost estimate, however derived, should be the cost that best estimates the price that would be charged in a competitive market. This would include the direct costs of the basic service[41], and a reasonable level of contribution toward shared and common costs.[42] There is no reason to assume that the proxy cost models the *Recommended Decision* proposes to consider include costs for other services. If the Commission believes that the cost estimates are not correct, that should be a matter for the cost workshops, and the Commission should not attempt to resolve it by dragging in revenues from other services.

2. Each service makes a contribution toward joint and common costs. Traditionally, local residential service prices have been set so that they generate a disproportionately low, and sometimes negative, level of contribution -- lower than the level a competitive market would set. Services such as access and vertical services have traditionally made a proportionately higher level of contribution -- higher than market levels. If the cost estimate, as described supra, includes a reasonable level of

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[41] Among these should be the cost of the local loop, which is a component of basic local service, and which is not shared with any other service.

[42] In principle, this should be a market level of contribution. Since local service is generally less elastic, the competitive market would most likely set a price which causes basic local service to carry a higher markup than other services. It would therefore be conservative to expect the basic service to generate at least a proportional contribution toward shared and common costs.

contribution, then there is no basis for capturing, and associating with the provision of local service, the contributions made by other services. The *Recommended Decision* expresses concern (at ¶ 315) that LECs would somehow collect revenue for discretionary services twice. In fact, under the average revenue proposal, exactly the opposite would happen: contributions toward joint and common costs generated by other service rates would be counted against the "reasonable" level of joint and common costs that basic local service is supposed to cover.

3. Even if costs and revenues were exactly matched, the result would still be wrong if any revenues not directly caused by local service were to be counted. This is so because the rates for these services contain different contribution levels today. If this concept were carried to its logical conclusion, we could simply count all costs and all revenues. Because ILECs in general have revenue sufficiency today, on this basis the funding need would always be zero in aggregate. Thus any attempt to "draw the balloon" around any set of services beyond the defined basic service will defeat the congressional purpose, which is to allow basic local service to stand on its own, through a combination of its own rates and the new, explicit funding mechanism -- without relying on any other service to generate implicit support.

Congress requires the FCC to create a universal service plan that is sufficient to preserve and advance universal service. Any determination of funding needs that relies on revenues from other services is not consistent with this mandate. When considering whether the plan ensures that the sufficiency requirement has been met, the Commission should consider only those revenues that are directly caused by the customer's decision to subscribe to basic local service. When considering, within this broader framework, what proportion of the necessary support should come from the federal plan, the Commission should consider criteria entirely different from those proposed by the *Recommended Decision*, which GTE will discuss *infra*.

C. The Proposed Forward-Looking, Theoretical Cost Methodology And The Resulting Cost Proxies Fail To Promote Universal Service As Required By The Act.

The *Recommended Decision* (at ¶ 309) proposes that carriers draw from the high cost fund based on the difference between an estimate of the costs for specific geographic areas as determined by a proxy methodology and a national average revenue benchmark. Further, the *Recommended Decision* (at ¶ 268) concludes that a "properly crafted proxy model can be used to calculate the forward-looking economic costs for specific geographic areas, and be used as the cost input in determining the level of support a carrier may need to serve a high cost area." The *Recommended Decision* is not able to select a proxy model for the time being, commenting (at ¶ 279) "the BCM2 and the Hatfield Model Version 2.2, Release 2 ("Hatfield Model") are the best available basis for the future development of an acceptable proxy model at this time."[43] To "best approximate the costs that would be incurred by an efficient

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[43] The Joint Board did indicate it would identify a preferred proxy model prior to the FCC's ruling on the Joint Board's recommendation. *Recommended Decision* at ¶ 269.

competitor entering that market,"[44] the Joint Board concludes that the technology assumed in the model "should be the least-cost, most efficient and reasonable technology for providing the supported services that is currently available for purchase."[45]

1. The cost estimate selected for use in the federal plan must correctly represent the actual cost of basic local service.

As explained *supra*, the universal service policy established by the Commission will set the price that carriers face in the market for local service. In order to promote local competition, and send efficient price signals for new entry, it is essential that this should approximate as closely as possible the competitive market price. In any competitive market, in order for the market to be in equilibrium, the average price in the market must cover the actual average cost of the providers in the market. Today, in the local exchange market, those providers are the ILECs.

At the same time, in order to satisfy the requirements of the 1996 Act, the new universal support mechanism must be "explicit and sufficient to achieve the purposes of [Section 254]" -- purposes that include, among others, the preservation and enhancement of universal service. Clearly, in order to be "sufficient," the plan must provide a level of funding which would cover the necessary costs of universal service providers. Further, in order to avoid a "taking" of the property of universal service providers, the plan must not deprive carriers of a reasonable opportunity to recover their prudently incurred costs.

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[44] *Id.* at ¶ 270.

[45] *Id.* at ¶ 277.

For all of these reasons, it is crucial that the cost measure chosen for use in the federal plan reasonably estimate the market price of universal service, which in turn should depend on the actual cost of providing the defined service. The *Recommended Decision*, by proposing to estimate the level of cost through the use of a proxy model, creates a significant risk that the cost estimate will be inaccurate. If the cost estimate deviates significantly from the actual costs of providing the service, the plan will be insufficient, will not be competitively neutral, and may create a taking of ILEC property.

Incremental cost models, based on engineering simulations, have traditionally been used in the industry to estimate incremental cost relationships, having to do with small increments of additional demand. Cost levels have been measured using accounting data, which record the firm's actual expenditure. Thus, while "forward-looking" costing has involved some simulation, the degree of extrapolation from actual experience has been very small, because the model was adding a small increment to an existing, actual network, and because the models were only being relied upon to estimate the slopes of cost curves, rather than absolute levels.

However, the "forward-looking" models on which the *Recommended Decision* proposes to rely are of an entirely different nature. These models simulate an entire network from scratch, rather than building a small increment upon an existing one. Further, the *Recommended Decision* proposes to derive an estimate of the cost level, and not just the slope of the cost curve, from the simulation. This procedure introduces a very significant risk that the cost estimate will be in error. Simulation models are based on very limited information, do not take into account all of the real-world variables that affect cost, and are very sensitive to changes in their data and assumptions.

This risk is greatly exacerbated because the *Recommended Decision* does not make any provision for validating the cost estimate produced by the hypothetical model against any actual observation of real-world cost experience. This approach assumes, in effect, that if there is any discrepancy between the model and the real world, the real world must be wrong. This is bad science, and an unreliable foundation on which to base a "sufficient" universal service plan.

There is good reason to be concerned that a forward-looking model may not produce estimates that bear any relation to actual cost data. Proxy models submitted to the Joint Board in this proceeding -- most particularly the Hatfield model -- systematically underestimate the actual cost of service.[46] The cost estimates recently used by the Commission to set recommended ranges for unbundled element prices were largely based on the Hatfield Associates Model, and were systematically lower than the embedded costs of the ILECs.

This strong doubt concerning the feasibility of using cost proxy models to evaluate actual cost levels is demonstrated by an analysis of why actual costs and the model's costs differ. The possible explanations for any discrepancy fall into three groups:

First, the embedded investment of the ILEC may not be valued correctly because of a failure to recognize, through depreciation, changes over time in the economic value of the plant. If new equipment can be placed at lower cost than in previous years, either because technology has improved or because input prices have fallen, then this

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[46] See Attachment 2 for a discussion of the many infirmities of the Hatfield Associates Model.

means that the economic value of the existing plant has fallen since it was installed. If correct economic depreciation had been used, this change would have been recognized as a cost of doing business during the time the company has owned these assets.[47] The depreciated, embedded plant should thus be just as "efficient," if valued correctly, as new plant would be.

If the cost of owning these assets in previous years was not properly recognized at the time, because the ILECs were required to use unrealistic depreciation rates instead of economic depreciation, then this represents a cost, not of future universal service, but of service in the past. This cost of providing universal service in the past has been deferred by the regulator as a matter of public policy, but it cannot continue to be recovered through ILEC service rates in a competitive environment.[48] A grave failing of the *Recommended Decision* is that it takes no account of deferred costs from universal service obligations in previous periods, and makes no provision for their recovery.

<u>Second</u>, it is possible that the ILEC investment was inefficient at the time it was placed, or that it has been operated in an inefficient manner. But, the *Recommended Decision* offers no evidence that this has in fact occurred. Indeed, GTE submits that

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[47] The *Recommended Decision* (at ¶ 277) effectively recognizes this point by calling for economic depreciation to be used in the development of the proxy estimates.

[48] Nor should recovery of the costs associated with underdepreciated facilities be part of the portable compensation made available on an ongoing basis to any carrier that undertakes an obligation to serve. Instead, since it is specific to the ILECs, it should be treated separately from the issue of ongoing universal service costs, and should be amortized through a fund created specifically for that purpose.

prior regulatory oversight largely negates any such assumption on the part of the FCC here.

Third, it is possible that the cost proxy estimate is in error. There are many possible sources of error in the construction of the proxy models, and in their inputs. The models represent the world at a high level of abstraction: Census Block Groups ("CBGs") are square, customers are uniformly distributed, and terrain is differentiated only to a very limited extent. The models do not know anything about obstacles, natural or manmade, that may constrain network design: rivers, highways, or zoning laws. The models do not optimize, but only implement the rules of thumb that are given to them. The models are static; they do not consider growth, uncertainty, indivisibilities of investment, breakage, or repeated placement costs. Real network managers must carry out a dynamic optimization, across all of these variables, over time. [49]

Application of the foregoing principles to the facts at hand reveals the following. First, underdepreciation is a recognized fact and must be accommodated by the FCC in its universal service policies. Second, there is absolutely no record evidence of LEC inefficiency, and it may not simply be assumed herein. Third, it follows that any

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[49] In order to represent this dynamic optimization problem, the proxy model cannot simply be designed to build on a one-time basis enough capacity to meet the current level of demand; this will always understate the true costs over any reasonable time horizon. Since the models do not optimize, they must approximate the solution to the optimization over time through the appropriate choice of inputs, such as fill factors and efficient capacity expansion increments. Note also that because any firm, incumbent or entrant, must optimize over time, there is no inherent difference between the costs of the incumbent and the cost of an efficient entrant. However, if the model does not capture dynamic optimization accurately, it may erroneously create the appearance of such a difference, since the incumbent's cost will include dynamic effects.

additional difference between the real world and proxy model results not accounted for by underdepreciation must result from errors in the model itself.

Accordingly, GTE submits that, in the absence of powerful evidence to the contrary, when the model contradicts reality, the Commission must accept reality. Given the hypothetical nature of the proxy costs, their abstraction, and the uncertainty over their inputs, as well as the fact that no one has ever thought it useful, until quite recently, to estimate absolute cost levels using an incremental simulation model, it is simply unreasonable to assume that these models produce a better estimate of the solution to the cost minimization problem than the actions taken by prudently managed firms, investing real money, and serving real customers over time. At the very least, the Commission, in order to justify an estimate which is less than the actual cost level experienced by ILECs, would have to provide a clear explanation of the difference, and compelling reasons why it should accept the model results over actual data.

2. If the estimates developed under the Joint Board's prescribed methodology underestimate actual costs, they will deny ILECs a fair opportunity to recover costs prudently incurred in execution of governmental mandates.

The methodology recommended by the Joint Board is disconnected from the actual costs prudently incurred by ILECs. There is no attempt in the *Recommended Decision* to provide any sort of mechanism for reconciliation and justification of any differences between cost estimates and the actual prudently incurred costs of ILECs; thus, there is no mechanism designed to assure due respect for the constitutional right of each ILEC to a fair opportunity to recover its costs prudently invested.

This contrasts with the essential fairness of the prudent investment rule, which requires a showing that the company made a bad and costly decision based on what was known at the time the decision was made. As phrased by Chief Justice Rehnquist in the *Duquesne Light* case, "the utility is compensated for all prudent investments at their actual cost when made (their 'historical cost'), irrespective of whether individual investments are deemed necessary or beneficial in hindsight."[50] Here, if cost estimates under the *Recommended Decision* fall short of actual costs prudently incurred, the effect would be equivalent to a disallowance of actual cost with no trace of a finding that this relates to any failure on the part of the company.

D. The Recommended Method Of Collecting Universal Service Funds Is Not Competitively Neutral, Relies Upon Implicit Subsidies, And Is Unnecessarily Burdensome And Complex.

The 1996 Act mandates that "[e]very telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service."[51] The *Recommended Decision* (at ¶ 807) proposes that funds be collected from telecommunications carriers on the basis of their "gross telecommunications revenues net of payments to other carriers"; but makes no explicit provision for telecommunications carriers to recover their contributions to the fund.

The proposed net revenue method, when coupled with the failure of the *Recommended Decision* to incorporate any automatic pass-through recovery mechanism for contributors, would not be competitively neutral and would unreasonably

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[50] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309 (1989).

[51] Section 254(d).

discriminate against incumbent LECs. Because it would not provide an explicit funding source, it would continue the support flows implicit in ILEC rates. Further, the proposed assessment method is unnecessarily burdensome and complex.

1. The *Recommended Decision*'s proposed method of assessing contribution obligations is not competitively neutral.

The *Recommended Decision* (at ¶ 809) declares that the use of gross revenues net of payments to other carriers is competitively neutral because "all contributing carriers will base their contributions in the same manner." This ignores the obvious point that different bases for assessing contributions will lead to different patterns of contribution across carriers, even if each basis is applied consistently. In fact, the Joint Board has recommended the method that will maximize the contributions made to the fund by the ILECs.[52]

This inequitable distribution of responsibility for generating the necessary funding is particularly unreasonable because the *Recommended Decision* makes no provision for carriers to recover the contributions from customers in an explicit, competitively neutral manner. Indeed, when the *Recommended Decision* touches on the subject of recovery at all, it is inconsistent. It recognizes (at ¶ 168) that a universal service fund

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[52] In a recent *Ex Parte* presentation, NYNEX estimated that under a net revenue method, ILECs will be responsible for 63% of the funding base, and IXCs only 25%. In contrast, on a retail revenue basis, LECs would have 47% of the funding base, and IXCs 43%. *See* Letter of Frank J. Gumper, NYNEX, to Commissioner Chong, CC Docket No. 96-45 (December 2, 1996). Economics tells us that the incidence of a tax depends not on who ostensibly collects it, but on the relative elasticities of demand and supply. This assumes, however, that the firm responsible for remitting the tax to the government can pass it through, either by building it into the price or by adding it to the customer's bill. That is why the pass-through issue is crucial to the reasonableness of the assessment method.

"ultimately will be recovered from customers through higher rates." Yet it rejects a surcharge as a means for accomplishing this (at ¶ 446) on the grounds that it would "violate the statutory requirement that carriers, not consumers, finance support mechanisms."

Similarly, the *Recommended Decision* (at ¶ 808) recognizes that carriers are permitted, under section 254, to pass through to users of unbundled elements an equitable and nondiscriminatory portion of their universal service obligation. Yet the *Recommended Decision* also asks the Commission to clarify that ILECs will not be permitted to build this pass-through into their unbundled rates. Clearly, if the recovery is permitted, but not within the rates themselves, this can only be accomplished through some kind of surcharge applied to the rates. But the *Recommend Decision* makes no provision for a surcharge. Further, while proposing the establishment of $2.25 Billion of <u>new</u> funding for education -- funding which does not replace any revenue being recovered through ILEC rates today -- the *Recommended Decision* does not suggest any mechanism which would allow carriers to generate the money they must remit to the fund for this purpose.

This confusion is one example -- among several --of the Joint Board's reluctance to address squarely the problems posed by universal service. It is clear that ultimately, as the *Recommended Decision* itself admits, all funding for universal service must come from customers, for the simple reason that all revenue comes ultimately from customers.[53] Commissioner Chong emphasizes this fact in her separate statement:

> Let us make no mistake about who will foot the bill for this universal service program. It is not the telecommunications carriers, but the users of telecommunications services to whom these costs will be passed through in a competitive marketplace.[54]

It is also clear that firms in existing competitive markets routinely pass-through to their customers increases in costs that are beyond their control.[55]

Over time, all revenue must come from customers, just as all investment must come from investors. Any effort to use investors as a revenue source must ultimately fail, because capital markets will respond either by withholding capital or by adjusting the terms at which it is supplied. Thus, while public policy makers can impose a one-time loss on existing shareholders -- giving rise to a takings issue in the process -- they cannot reasonably expect to rely on shareholders to provide revenue to fund universal service programs. Unfortunately, they can, in attempting to do so, do very significant harm to the competitive market.

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[53] While the effect of a "tax" will be divided, according to relative elasticities, between an increase in price and a reduction in quantity, neither of these effects leads to the owners of the firm actually generating any revenue. The customer simply "pays" in part through a higher price, and in part by consuming less.

[54] Separate Statement of FCC Commissioner Rachelle B. Chong ("*Chong Statement*") at 14. *See also*, Separate Statement of Commissioner Laska Schoenfelder at 6.

[55] *See* Letter of Steve Case, Chief Executive Officer, America Online, Inc., Robert J. Massey, President and Chief Executive Officer, CompuServe Incorporated, William Schraeder, President, PSINet, Inc., and Paul W. DeLacey, President and Chief Executive Officer, Prodigy Services Corporation, to the Honorable Reed Hundt dated November 15, 1996, at 2.

Because the Joint Board does not squarely face this essential fact, it makes incorrect determinations with respect to those funding issues it does address. It fails to consider the use of a surcharge, which is the most explicit and competitively neutral method of recovery, on the grounds that carriers, not customers, must be the source of funding. This reasoning is clearly in error, because all recovery must ultimately come from customers, as Commissioner Chong, and the *Recommended Decision* itself, acknowledge.[56] In fact, other than the new $2.25 billion of support proposed for schools and libraries, adoption of a surcharge does not mean that in total consumers will pay more, because some rates that currently provide implicit support will be reduced on a dollar-for-dollar basis to equal the amount of explicit universal service support provided from the fund.

The impact of the Joint Board's proposal would also not be competitively neutral, since some firms have the freedom to pass through their contributions in the form of rate increases or surcharges to their customers, while ILECs, whose rates are

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[56] In its recent decision adopting a state universal service plan, the California Public Utility Commission ("CPUC") rejected similar arguments by a party in the state proceeding. "We are not persuaded by TURN's argument that the Telco Act was intended to prevent us from setting up an AEUS to fund the CHCF-B. Despite the language in Section 254(k), we agree with ICG that it is highly unlikely that Congress intended that carriers only, and not their customers, should contribute to the national fund. This is especially true since carriers are likely to pass that charge on to its customers." Decision 96-10-066 at 184-184 (October 25, 1996).

constrained by regulation, do not have this freedom.[57] The *Recommended Decision* acknowledges this problem (at ¶ 808), but proposes no steps to address it. Thus, the recommendation is not neutral with respect to competing firms, since ILECs will be uniquely disadvantaged. It is also not neutral in its effect on customers' choices among different services and technologies, because the prices for these services will be affected in a non-uniform way. The proposal therefore violates the competitive neutrality principle and the underlying pro-competitive foundation of the 1996 Act.

2. The *Recommended Decision*'s proposed method of assessing contribution obligations will perpetuate implicit support from other services.

Because the Joint Board does not adequately address the need for a recovery source for universal service funding, it will leave in place much of the implicit support that is generated today by rates for other telecommunications services, such as access, toll, and vertical services. The new, explicit support provided to ILECs by a correctly designed universal service fund should be sufficient to fund offsetting reductions which would remove the implicit support contributions from those other service rates.

However, the net revenue approach proposed by the *Recommended Decision* (at ¶ 807) does just the opposite. It simply raises the cost level of the carriers who

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[57] Except for the limited set of rates over which the LECs may have some pricing discretion -- such as price cap rates where there is existing headroom under the cap -- LECs would have to seek permission from the Commission, and from state regulators, to effect a pass-through in their rates, a process which will be both time-consuming and uncertain. It is extremely unlikely, in the absence of an explicit recovery provision in the universal service plan itself, that the ILEC would be able to effect a broad, across-the board adjustment to its rates. This will increase all the problems addressed in these comments involving the denial of an opportunity to recover costs prudently incurred.

must contribute. By doing so, it will ratify, rather than correct, the rate levels of services that are contributing today. Carriers who have been charging these high prices will not be able to make offsetting reductions equal to the gross amount of support they receive from the fund. Instead, they will only have available any net amount they may receive -- the difference, if any, between their receipts from the fund and their contributions to it. In a recent California PUC proceeding, GTE demonstrated that only about one-third of the total fund amount would be available to pay for offsetting reductions. This means that, even if the fund is sized correctly -- an unlikely outcome, given other deficiencies in the *Recommended Decision* -- most of the implicit support generated through rates today will still be in place after the plan is implemented.[58]

3. The *Recommended Decision*'s proposed method of assessing contribution obligations is overly complex and unnecessarily burdensome.

The *Recommended Decision* (at ¶ 807) also suggests that the use of gross revenues net of payments to other carriers would be administratively easy to implement because the Commission already collects common carrier regulatory fees on this basis. The fact that this method is currently used does not mean that it is or will remain the most simple and straightforward method -- only that it was previously chosen. The amount of revenue collected in this way is small, compared to the funding needs for

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[58] The Commission is running out of opportunities to address the implicit subsidy issue. Given the 1996 Act's clear directive as well as the Commission's prior action in the *Interconnection Order*, and expected action in the access reform proceeding, now is the time to address the implicit subsidy issue. The reduction in revenues due to removal of implicit subsidies from current rates must be addressed through a combination of rate rebalancing and explicit universal service funding mechanisms if the Commission is to have any expectation of meeting the statutory directive to preserve and advance universal service on a pro-competitive basis.

universal service, and the world in which this system is currently administered is relatively simple, compared to the environment in which the federal funding mechanism will have to be effective.

The problem with the proposed method is that it forces both carriers and the fund administrator to keep records that track all intermediate transactions. The *Recommended Decision* recognizes (at ¶ 317) that the nature of the telecommunications marketplace is likely to change, and that "carriers may package local and long distance services as part of their array of service offerings to the public in order to distinguish themselves from other providers of telecommunications services." It is highly likely that many carriers will create packages of services using a variety of underlying services.[59] A net revenue approach would require tracking of all the intermediate transactions in this increasingly complex market structure. For each of these transactions, it would be necessary for the firm claiming a credit to demonstrate that all of the payment in the transaction was for telecommunications services, and that payments for the telecommunications services used were included in the suppliers' determination of their fund obligations.[60]

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[59] For example, a retail packager could offer customers a full range of communications services through a combination of self-supply and functionality obtained from a large number of sources, *e.g.*, unbundled loops from one or more ILECs, CATV firms and CMRS providers; unbundled switching from other sources; SS7 signaling from an independent vendor; interexchange services from multiple IXCs; wireless services from more than one CMRS provider; and paging from another entity.

[60] While ILECs would have the largest share of net revenue, it is not the case, as the *Recommended Decision* appears to assume (at ¶ 809), since settlement payments among ILECs, and payments for termination of traffic to CLECs, would be counted as payments to other carriers.

In contrast, a plan based on retail revenue need only record one transaction at the end of this chain, when the end-user purchases the service. California has successfully administered an All End User Surcharge ("AEUS") for several years, raising more than $300 million per year to fund its Lifeline program. It has recently decided to use a similar surcharge to fund its high cost and education funds as well.

E. Reducing the Subscriber Line Charge and Continuing To Use The Carrier Common Line Charge Would Force Continued Reliance On Implicit Subsidies In Violation Of The 1996 Act.

The *Recommended Decision* (at ¶ 773) suggests that the decreases in common line costs due to the elimination of pay telephone costs[61] and the recommended removal of Long Term Support (LTS) payments should be "apportioned equally between primary residential and single-line-business subscribers to local exchange service, on the one hand, through a reduction in the S[ubscriber] L[ine] C[harge] cap for those lines, and interstate toll users, on the other hand, through lower CCL charges."

The FCC should not adopt the recommended SLC cap reduction because it would result in continuation of the implicit subsidy provided through the CCL charge in violation of the mandate in Section 254(e) of the 1996 Act that all support be explicit. In fact, Chairman Hundt has identified this very flaw with the CCL rate structure -- it "makes high-volume users subsidize lower-volume users."[62] This simply means that

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[61] *See Implementation of the Pay Telephone Reclassification Provisions of the Telecommunications Act of 1996*, Report and Order, CC Docket No. 96-128, FCC 96-388 (rel. Sept. 20, 1996) (*recon. pending*) ("*Pay Telephone Order*"), at ¶ 181.

[62] "Fifty-Nine Million Consumers Might Be Right," Speech by Reed Hundt, Chairman, Federal Communications Commission, to the National Consumers Week Symposium, Washington, D.C., October 26, 1995, at 3. ("*Hundt Fifty-Nine Million Speech*").

customers with large amounts of long distance calling are today forced to pay a portion of the costs caused by low volume customers, and under the *Recommended Decision*, would continue to provide the subsidy.

Continued use of a CCL rate element also fails to be competitively neutral and violates the "pro-competitive" intent of the 1996 Act. Chairman Hundt has correctly predicted that when "competition hits the local exchange market the system cannot continue"[63] because the usage sensitive recovery of fixed costs by incumbent LECs in the face of competitors that can charge flat rates will "doom incumbent LECs to losing high volume customers."[64]

The *Recommended Decision* does not provide a useful basis for considering changes to the recovery of common line costs, including the elimination or dramatic reduction of the CCL rate element, because it refuses to recognize that common line recovery is related to universal service at all. If accepted, this premise would make it impossible for the Commission to complete the task of establishing efficient SLC pricing that it began thirteen years ago.

F. The Totality Of The Recommendations Will Cause A Violation Of The Fifth Amendment.

The Joint Board's recommendations, if adopted, would not only violate the 1996 Act, but would also raise serious constitutional problems as to whether they would amount to a taking of private property for public use without just compensation in

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63 *Id.*

64 Speech by Reed Hundt, Chairman, Federal Communications Commission, to the National Association of Regulatory Utility Commissioners, San Francisco, California, November 20, 1996 ("*Hundt NARUC Speech*").

violation of the Fifth Amendment. The totality of the *Recommended Decision*'s scheme, including the use of forward-looking theoretical costs, an unreasonable benchmark, the lack of any pass-through mechanism, and the proposed reduction in the Subscriber Line Charge, result in a taking without just compensation. If the Commission, acting on the *Recommended Decision*, adopts a proxy cost measure which systematically underestimates the ILECs' actual cost, then it will have taken the ILECs' investments, together with the services provided by them, for the public good without fulfilling government's part of the bargain by allowing LECs a full opportunity for recovery of prudently incurred costs.[65]

The Takings Clause provides that "private property" shall not "be taken for public use, without just compensation."[66] The right to possess and use property is a fundamental element of our property rights.[67] Therefore, one of the principal purposes of the Takings Clause is "to bar government from forcing some people alone to bear public burdens which, in all fairness and justice should be borne by the public as a

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[65] Although GTE believes the Commission's universal service proposal must provide adequate cost recovery on its own, the Commission has foreclosed other potential avenues for recovery of these costs in its decisions regarding resale and interconnection, and may do likewise in its access charge reform proceeding. The Commission must not continue to put off until "the next proceeding" the recovery of these costs because the Commission is running out of proceedings. It is also wholly inadequate to assert that universal service providers can recover their costs via state regulatory action. It is the federal regime that is taking the "private property" for "public use" and it is the federal government that must therefore provide the "just compensation."

[66] U.S. Const. amend. V.

[67] *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945).